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IN THE

Supreme Court of the United States

October Term, 1940

No. 335

ALAMITOS LAND COMPANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT AND BRIEF IN SUPPORT THEREOF.

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IN THE

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October Term, 1940

No. .....

ALAMITOS LAND COMPANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT.

The petitioner prays that a writ of certiorari issue to review the judgment of the Circuit Court of Appeals for the Ninth Circuit entered in the above entitled cause on June 10, 1940, reversing an order of the United States Board of Tax Appeals.

Opinions Below.

The opinion of the United States Board of Tax Appeals was rendered July 28, 1939, Record pages 23 to 50, and is reported in 40 B. T. A. 353. The opinion of the Circuit Court of Appeals, Record pages 138 to 148, inclusive, is reported in 112 Fed. (2d) 648.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered on June 10, 1940, Record 149. The jurisdiction of this Court is invoked under Section 240-a of the Judicial Code as amended by Act of February 13, 1925.

Questions Presented.

1. Whether, under the circumstances of this case, petitioner realized taxable income in the year 1932 when it received the amount of $522,895.11 paid to it by Shell Oil Company during the pendency of a court controversy under compulsion of a court order later determined to be erroneous, which determination required petitioner to return the money to Shell. Petitioner's average income, against which the restitution might be deducted, was about $60,000 a year.

2. If the receipt in 1932 constituted income to petitioner, was petitioner taxable on more than 65% of such receipt, when it had previously agreed to pay to Shepard-Pendleton, Ltd. 35% of any recovery in the litigation?

3. Whether petitioner realized taxable income in the years 1932 and 1933 on account of interest accrued on the $522,895.11 which had been placed on time deposit by petitioner pending the outcome of the litigation, said interest having been turned over to Shell on the reversal of the lower court's decision.

4. If petitioner is taxable on the interest on said litigated fund, is it taxable on more than 65% thereof, when it had the contractual obligation to pay to its associates 35% of any recovery?

Statute Involved.

Section 22(a) of the Revenue Act of 1932, reads as follows:

> "(a) General definition.—'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever."

Statement.

This case involves income tax deficiencies for the years 1932 and 1933 of $28,978.21 and $2,478.93 respectively [Record, p. 4] resulting from the determination of respondent, the Commissioner of Internal Revenue, that petitioner received taxable income in 1932 from the receipt of monies paid to it by Shell Oil Company during the pendency of a court controversy under compulsion of a court order later determined to be erroneous, and from the determination of the Commissioner that interest realized on said fund (which was placed in a special account), was taxable income to the petitioner for the years 1932 and 1933.

In 1921 petitioner leased to Shell Oil Company certain land for the development of oil and gas upon a royalty of 16-2/3% of the oil and gas produced and saved, which royalty was payable monthly. The property has been producing oil and gas since 1921 [R. 21] and since that

time petitioner has accrued as income on its books and tax returns in December of each year the December royalty, payable in January. [R. 74.]

On September 1, 1930, petitioner entered into a written contract with Shepard-Pendleton, Ltd. a corporation engaged in petroleum engineering work, by the terms of which Shepard-Pendleton was engaged to check the method which Shell had used in determining the quantity and quality of the oil produced from the leased premises and the methods of computing the royalties to be paid to petitioner. [R. 65.] Petitioner agreed to pay to Shepard-Pendleton for its services a sum equal to 35% of the amount recoverable from Shell whether with or without litigation, Shepard-Pendleton was to pay all attorney's fees and court costs. [R. 74.] The agreement related only to oil and gas and gasoline produced, saved and sold under the lease up to but not including September 1, 1930. [R. 78.] Shepard-Pendleton checked the method by which Shell had determined the quantity and quality of oil produced on the leased premises for the purpose of computing royalties and caused to be brought on behalf of petitioner in 1931 a suit against Shell for additional royalties up to August 30, 1930, and for the cancellation of the lease on the ground that Shell had failed to make proper accounting of royalties. [R. 65-66.]

In April, 1932, the Superior Court of the State of California gave judgment to petitioner, the plaintiff in said suit, in the amount of $522,895.11, representing additional royalties from the date of discovery of oil in 1921 to September 1, 1930, in the amount of $490,805.75, together with interest in the amount of $31,226.86 and court costs of $862.50. The judgment also declared the termination

of the lease but provided that Shell would be relieved of such forfeiture in the event it paid to petitioner on or before August 29, 1932, all sums for which judgment was given. [R. 66.]

Shell, in order to prevent a forfeiture, tendered to petitioner on July 8, 1932, a cashier's check for $522,895.11. Acompanying said check was a letter from Shell to petitioner which stated that the payment of said sum was made only in order to avoid the forfeiture decreed by the judgment and was made involuntarily and solely by virtue of the duress, coercion and compulsion of the judgment, and that Shell did not in any way relinquish its rights of appeal from any and all parts of said judgment or to recover the payment of said sum given to the extent that said judgment might be reversed or modified upon appeal, or to take such other step or action as Shell might deem appropriate to protect itself and its interests in the premises. [R. 66-67, 91-92.]

On July 14, 1932, Shell took an appeal to the Supreme Court of the State of California from all portions of the judgment of the Superior Court with the exceptions of Paragraphs 6 and 7 thereof. Petitioner took an appeal to the said Supreme Court from Paragraphs 6 and 7 of the judgment. [R. 67.]

Petitioner, on September 22, 1932, deposited the check for $522,895.11 in a Long Beach Branch of the Security-First National Bank of Los Angeles, in a time deposit account bearing interest at the rate of 3½% per annum. [R. 69.] Upon its books petitioner made a journal entry debiting "Deposit in connection with pending action vs. Shell Oil Company—$522,895.11" and crediting "Reserve for contingent liability in connection with pending action

vs. Shell Oil Company—$522,895.11." The journal entry then contained an explanation reciting the conditions under which Shell made the payment, and that with the approval of Shepard-Pendleton "who has a considerable interest in the amount of said judgment" the funds were deposited as mentioned above. [R. 106-107.]

In its 1932 income tax return, petitioner excluded from income the amount received from Shell and the interest earned thereon, explaining in a statement attached to the return the entire situation; further stating that the funds must be held intact until there was a final determination of the case by the higher courts. [R. 74-75.] In its 1933 return, petitioner excluded from taxable income the $18,-208.57, increase in funds in the special account, stating that no portion of said funds had at any time been considered or used as income, the deposit being kept intact pending decision by the State Supreme Court. [R. 76.]

On April 26, 1935, the Supreme Court of California reversed the judgment of the lower court in the portions of the judgment which were in favor of petitioner and affirmed said judgment as to the portions thereof which were in favor of Shell. The Court remanded the cause for further proceedings in accordance with its holdings. [R. 70.]

On June 4, 1935, petitioner paid to Shell, in compliance with the latter's demand for restitution, the sum of $522,895.11 plus $41,256.90, being the interest actually received by petitioner during the time said principal had

been in its custody, and the sum of $11,595.31, representing profits accruing from the purchase and sale of United States Treasury notes. [R. 70.]

In 1935 petitioner filed an amended complaint against Shell in the Superior Court and Shell, after a motion to dismiss said amended complaint had been denied, filed an answer, leaving the case at issue in the spring of 1938. [R. 71.]

While the case was pending trial, the parties, in 1938, entered into an agreement settling the case whereby petitioner received $100,000, each party paying its own court costs. Petitioner settled with Shepard-Pendleton, Ltd. by paying them $25,000.00, and paid special counsel employed in connection with the litigation $2,500. [R. 73.]

In its 1935 return, petitioner did not claim any deduction on account of having returned to Shell the $522,895.11 plus accretion, but after paying a Federal income tax of $7,081 for 1935, petitioner filed a claim for refund for that year for $7,081 on the ground that if the $522,895.11 was held to be taxable income to the petitioner in the year 1932, said amount would be deductible in 1935. This claim was filed before petitioner settled its litigation with Shell but has not been acted upon by the Commissioner of Internal Revenue. Petitioner's income for 1935, without any deduction on account of the restitution to Shell, was $51,498.18. [R. 73-74.]

It was estimated at the trial that petitioner would have a taxable income in 1938 of $114,463.75 including the

$100,000 received from Shell in the settlement of the litigation and after deducting attorney's fees of $27,500.00 and depletion of $27,500.00 on the $100,000 received from Shell. It was further estimated at the trial that petitioner would have a net taxable income in 1938, without regard to any items in connection with the Shell litigation, of $69,463.75. [R. 123, 125.] Petitioner's income for 1932 and 1933, without regard to the Shell litigation, was $70,410.47 and $48,210.21 respectively, its average income being around $60,000 a year. [R. 12-13.]

Specification of Errors to Be Urged.

The court below erred:

1. In holding that petitioner received taxable income in 1932 on account of the receipt of monies from Shell.

2. In failing to hold that 35% of said monies received from Shell was, if taxable income to anyone, the income of Shepard-Pendleton, Ltd., and not that of petitioner.

3. In holding that petitioner received taxable income in 1932 and 1933 in the form of interest on the fund received from Shell.

4. In failing to hold that 35% of the interest from the Shell fund if not taxable to Shell was taxable income to Shepard-Pendleton, and was not the taxable income of petitioner.

Reasons for Granting the Writ.

1. The court below has decided a Federal question in a way probably in conflict with applicable decisions of this Court.

In *Eisner v. Macomber,* 252 U. S. 189, this Court defined income subject to taxation under the Sixteenth Amendment and under the Revenue Act, and held that the attempt to tax anything else under the income tax law would violate the provisions of Article 1, Section 2, Clause 3, and Article 1, Section 9, Clause 4 of the Constitution, prohibiting the laying by Congress of direct taxes without apportionment. This Court said that what is and what is not income is to be determined according to truth and substance, without regard to form. The Court pointed out in its definitions of income that it must be gain derived from capital or labor, or both combined; it must proceed from the property, be severed from the capital and be received or drawn by the recipient for his own separate use, benefit and disposal. This Court pointed out, in considering whether a stock dividend was income, that it would be necessary to sell some of the stock in order to pay the tax and nothing could more clearly show that to tax the stock dividend was to tax capital increase and not income, than that in the nature of things it requires a conversion of capital in order to pay the tax.

In the case at bar, the petitioner received money from Shell with notice that it was paid under protest and that Shell intended to attempt to get it back on appeal. Peti-

tioner did not treat the money as its own on its books or otherwise but segregated it as a fund which might have to be returned. Petitioner was required to return the money and if it has to pay tax on the receipt, it will have to pay it out of its other capital funds. It cannot pay it out of its saving in tax in the year in which it paid the money back as its income was so small that the tax saving in that year would be insufficient by a large margin to pay the tax.

In *Bowers v. Kerbaugh-Empire Company*, 271 U. S. 170, this Court held that in determining whether an item was income, it was necessary and proper to look at the entire history of the transaction even though it might cover a period of years. In that case the taxpayer had borrowed money in 1913, repayable in German marks. The money had been lost in business transactions but the loan was repaid in depreciated German marks and at an apparent book profit. This Court held that where the result of the whole transaction was a loss, the mere diminution of the loss was not gain, profit or income. The Court pointed out that although the taxpayer, or its subsidiary company, took deductions for the losses in the several years in which they were sustained, these deductions did not benefit it from a tax standpoint as it had losses before these deductions were taken.

In the case at bar, over the entire period of years involved, the petitioner did not actually gain anything from its litigation with the Shell Company excepting the money which was received in 1938 on the settlement of the litigation. It is, of course, willing to pay tax on its portion of that sum in whatever year it is proper to do so. The right to take a deduction in the year of restitution or

settlement of the amount received from Shell does not make the receipt in 1932 taxable income as the deduction would not benefit taxpayer for income tax purposes since its income was greatly inadequate to this deduction.

In *Freuler v. Helvering,* 291 U. S. 35, the beneficiaries of a trust received from the trust amounts in excess of the distributable income to which they were entitled but were later required to return the excess to the trustee. This Court held that the beneficiaries were taxable only on the amounts which should have been distributed to them, on the theory that the test of taxability to the beneficiaries was not the receipt of income but the present right to receive it and that an overpayment to the beneficiary by mistake of law or facts would render him liable not on the amount paid but on that payable.

Petitioner received the money from Shell on a mistake of law and had to return it, or in the long run, part of it, and should, under the authority of the *Freuler* case, be taxable only on the amount which should have been paid to it.

In *United States v. Safety Car Heating and Lighting Company,* 297 U. S. 88, and *Sanford and Brooks,* 282 U. S. 359, this Court held that amounts in litigation were not taxable income to the eventual recipient until its right thereto had been upheld by the highest court of appeal or settlement.

There is no reported case of a taxpayer receiving money in litigation and eventually being required to pay it back wherein this Court held that the temporary receipt was taxable income.

2. The court below has decided an important question of local law in a way probably in conflict with applicable local decisions. Under California law, an executory contract between two parties that one should have as compensation for services, a stipulated percentage of the proceeds of a judgment to be recovered for the other, operates as an equitable assignment *pro tanto*. *Hoffman v. Vallejo,* 45 Cal. 564; *Luco v. DeToro,* 91 Cal. 405, 27 Pac. 1082; *Elliott v. Leopold Mining Company,* 52 Cal. 355. To the same effect, generally, see *Wooster v. Trowbridge,* 120 Fed. 667; *Hawk v. Ament,* 28 Ill. App. 390; *Driband v. Candler,* 166 Mich. 49, 131 N. W. 129; *Bent v. Lipcomb,* 45 W. Va. 183, 31 S. E. 907; *Curtis v. Metropolitan Street Railway Company,* 118 Mo. App. 341, 94 S. W. 762; *Texas C. R. Co. v. Andrews,* 28 Tex. Civil Appeals 477, 67 S. W. 923; *Coughlin v. N. Y. C. and H. R. R. Company,* 71 N. Y. 443, 2 A. L. R. 454.

In the case at bar, petitioner agreed to pay to Shepard-Pendleton, Ltd. 35% of any amount recovered from Shell. Should the receipt from Shell in 1932 constitute income, 65% thereof only would constitute income to the petitioner and 35% to Shepard-Pendleton, Ltd. The court below held that the entire amount received from Shell was taxable in 1932 to petitioner.

3. The decision of the court below is in conflict with *Great Southern Life Insurance Company v. Commissioner,* 89 Fed. (2d) 54, wherein the court affirmed without discussion the decision of the Board, 33 B. T. A. 512, that the taxpayer there involved was not taxable upon interest received on bonds held by it but which bonds it subsequently had to pay over to the rightful owner on a court order. There, the taxpayer had loaned $95,000 to one

Toombs, secured by bonds of the village of Lansing, Illinois, of a par value of $120,000. By December 31, 1928, interest had accrued on said loan in the amount of $4867.22. As of December 31, 1928, the taxpayer appropriated the bonds of the value of $99,867.22 to its own use, marking the indebtedness as having been paid as to principal and interest. Prior to appropriating the bonds as mentioned above, a bank in Illinois had notified the taxpayer that some of the bonds had been stolen from it and had demanded the return of them. The taxpayer refused to turn the bonds over to the said bank and the bank sued the taxpayer and the court awarded to the bank, bonds of the par value of $52,500, which the taxpayer turned over to the bank. The taxpayer had included in taxable income in 1928 the interest from the bonds of the par value of $52,500 which it subsequently gave up. The Board of Tax Appeals held that the taxpayer was not taxable on the interest allocable to the $52,500 in bonds which it subsequently had to give up. The Circuit Court of Appeals for the Fifth Circuit affirmed the decision of the Board without discussion of this point.

In the case at bar, the petitioner received the monies from Shell after Shell had notified it of its intention to attempt to recover the money and the petitioner was required to return the money to Shell.

4. The decision of the court below is in conflict with *Commissioner v. Turney,* 82 Fed. (2d) 661. In that case a bonus for granting an oil lease was received in one year, but the taxpayer was taxed on only one-half thereof. The lease provided that the bonuses would be paid to the lessor who would pay one-half of them over to the State of Texas if, by decision of the Supreme Court of Texas,

it should thereafter be determined that the state was entitled to a portion of the bonuses.

When the bonus was received by the taxpayer Turney, he used it generally in his business and has never paid any part of it over to the State, back to the lessee, nor to anyone else. The State of Texas sued the lessee for a half of the bonus and the lessee made a demand in writing upon Turney that he either pay a half of the bonus to lessee or to the State. It is entirely possible of course that the Supreme Court of Texas will hold against the State of Texas and not require the lessee or Turney to pay to the State of Texas one-half of the bonus.

At one time the State of Texas passed an Act which no longer required the lessors to pay half the bonuses to the State. While that particular Act was held unconstitutional it is entirely possible that the State of Texas may again pass similar legislation and Turney may never have to give up half of the bonus.

In the case at bar, petitioner was required by the terms of its contract to pay 35% of the amounts received from Shell to Shepard-Pendleton, Ltd., but the court below held that petitioner was taxable on 100% of the amount received from Shell, and the two cases are in conflict, at least as to the 35%. As shown by the dissenting opinion in the *Turney* case, it is probable that the decision is in conflict with the *Alamitos* case on the other 65% of the royalties received in litigation and returned by the petitioner herein.

5. The decision of the court below is in conflict with *Stoner v. Commissioner,* 79 Fed. (2d) 75, as to 35% of the monies received in 1932 from Shell. In the *Stoner*

case the principal stockholder of a company had entered into an agreement on behalf of all the stockholders to sell all the stock of the company for $1,250,000 with the provision that Stoner was to retain $50,000 as a tax reserve fund and after holding it for two years to turn over to all the stockholders any unused portion. The court held that he was not taxable in the year of sale on his portion of the $50,000, although the court recognized that he might have been but never was required to use the funds for the payment of the corporation taxes.

In the case at bar, the petitioner, by virtue of its contract with Shepard-Pendleton, Ltd., received the 35% from Shell as agent for Shepard-Pendleton, Ltd., and not as its own money.

6. The decision of the court below is in conflict with *Doyle v. Commissioner,* 110 Fed. (2d) 157, decided by the United States Circuit Court of Appeals for the Second Circuit on March 4, 1940. In that case the taxpayers contracted to sell in 1929 for $185,000 property which cost them $17,000. They received a down-payment in 1929 of $35,000 and a further payment in 1930 of $25,000. In 1931 when the contract was to be closed, the buyer refused to accept the deed or to pay the money. Eventually the taxpayers sued for specific performance and the buyer counter-claimed for the recovery of the $60,000 theretofore paid. In 1934 the complaint and counter-claim were both dismissed; the complaint on the ground that the plaintiffs were guilty of laches, and the counter-claim on the ground that it was grounded on a mere pretense. The taxpayer in the *Doyle* case contended that the money had been received in 1929 and 1930 under a claim of right and it, or most of it, was income in those years although there

was a possibility that it might have to be returned if there was a failure of consideration. The Circuit Court of Appeals held that the $60,000 was income in 1934 and not in any of the earlier years, although it was received in 1929 and 1930 under a claim of right and a large portion of it at least would have been taxable income even if the sale had been completed. Petition for writ of certiorari has been filed in the *Doyle* case and is waiting disposition by this Court.

7. If and to the extent that the decision below does not conflict with the above mentioned Supreme Court or Circuit Court decisions, then the Court has decided an important question of Federal law that has not been but should be decided by the Supreme Court.

The court below has decided that, where a taxpayer brings a suit for money and receives it as a result of the lower court's decision, it is income, even though he has to return it and its income in the year of restitution is wholly inadequate to absorb the deduction.

The important question here is not the year in which this item should be taxed, but is it income in the constitutional sense.

This Court, in *North American Oil Consolidated v. Burnett,* 286 U. S. 417, in a case where the taxpayer received money as a result of a decision of the lower court and was eventually permitted to keep the money, held the income taxable in the year in which received even though it was still claimed that it was not entitled to re-

tain the money. The Court (p. 424) then went on to use language which was not applicable to the facts of the case then before it, as follows:

> "* * * and even though he may still be adjudged liable to restore its equivalent * * * If in 1922 the Government had prevailed, and the company had been obliged to refund the profits received in 1917, it would have been entitled to a deduction from the profits in 1922, not from those of an earlier year * * *."

This language no doubt seemed appropriate to the court in a case in which the taxpayer was eventually permitted to keep the money, but should not of course be binding in a case where the taxpayer was required to give up the money; furthermore, it should be noted that in the *North American* case, a large corporation with many properties and large income was before the court whereas the item in dispute was relatively small in comparison with the normal income of the corporation. It was assumed that if the taxpayer had been required to give up the money in 1922 it would have had sufficient income to absorb that deduction.

In the case at bar, however, the taxpayer involved is a small corporation with an average income of around $60,000 a year while the item in dispute is over $500,000, so that if it were taxed on $500,000 extra income in 1932 but got a $500,000 reduction in 1935 or 1938 against an income of $60,000, it would be slight consolation. While the language above quoted from the *North American* case

is undoubtedly *obiter dictum,* it has been applied by the Treasury Department and by the courts in circumstances far different from those involved in the *North American* case; as for example, in the case at bar.

The *obiter dictum* in the *North American* case, rather than the holding of the case, is being applied by the Treasury Department and the lower courts to cases where its application violates the Constitution of the United States. This Court ought to consider a case where the facts involved are like those mentioned in the *dictum* (with the added factor that there is very little or no income against which to take the large deduction) and impress upon the Treasury Department and the lower courts that only the holding in the *North American* case is to be followed and to limit the application of the North American case to situations where the taxpayer received the money, and though it may be claimed that he is liable to turn it over to others, he is not later required to do so unless the size of the item was such that it would be entirely probable that he could deduct it from income in subsequent years.

The Prentice-Hall Citator shows that Point 4 in this Court's opinion in the *North American* case has been cited seventy-five times in the last eight years. It is thus apparent that the taxation of items in litigation is an important subject.

The *obiter dictum* in the *North American* case adds greatly to the confusion on the question and the case at bar affords an opportunity to clear up the subject to considerable extent and thus avoid much future litigation.

Conclusion.

Wherefore, it is respectfully submitted that this petition for writ of certiorari should be granted.

Respectfully submitted,

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Dated: August 8, 1940.